Supreme Court, U.S.
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No. 98-1736

IN THE

Supreme Court of the United States

DAVID M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION and JOHN S. NADOLSKI,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Did the district court correctly apply the concept of loss causation to the facts of this securities fraud case?

STATEMENT PURSUANT TO RULE 29.6

Respondent Marietta Corporation is a wholly owned subsidiary of BFMA Holding Corp., which is privately held. Therefore, there are no publicly held companies that own 10% or more of Marietta Corporation's stock.

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STATEMENT OF THE CASE

In March 1989, Respondent Marietta Corporation purchased Petitioner Donald Rowe's 90% interest in American Soap, Inc., a soap manufacturing company (the "Purchase"). In exchange, Petitioner received, among other things, several million dollars in cash, a lucrative employment contract, restricted shares in Marietta Corporation and a right (referred to as the "Earnout") to a contractually determined percentage of the profits of Marietta Corporation, above certain thresholds, for the five years following the Purchase. At the time of the Purchase, Petitioner valued the Earnout at approximately $3,600,000. (Pet. App. 39a).

Economic circumstances caused a significant decline in the profitability of Marietta, and it was revealed in 1991 that Marietta had been fraudulently inflating its earnings for some period of time both preceding and following the Purchase. (Pet. App. 47a-49a). The value of Petitioner's shares fell, and Petitioner received $69,876 under the earnout. (Pet. App. 100a).

Petitioner brought suit in the United States District Court for the Western District of Tennessee, alleging, *inter alia*, breach of contract, common law fraud, securities fraud in violation of 15 U.S.C. § 78j and violation of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-64 (1984) (as amended). Several of the claims were dismissed before or during trial. The parties waived a jury, and a trial was held, followed by post-trial briefing. The district court made extensive findings of fact and conclusions of law, (Pet. App. 22a-116a), finding that Petitioner had established Respondents' liability for

common law fraud and securities fraud, and that Petitioner's remaining claims were without merit (Pet. App. 72a-73a & n.39). Applying the out-of-pocket method of calculating damages, the district court found that Petitioner's damages totaled $395,717, plus prejudgment interest. (Pet. App. 107a-108a, 111a-112a). In the course of calculating Petitioner's damages, the district court made a factual finding that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a).

The principal argument on Petitioner's appeal was that the district court had erred in awarding him no damages in connection with the Earnout. The court of appeals, however, found no error in the district court's finding:

> Instead of bargaining for a sum certain, [Petitioner] accepted a risk that the merged corporation would meet the earnout thresholds. He must accept the value of the right to the earnout at the time of the transaction. Thus, in calculating out-of-pocket damages, $3.6 million was considered part of the "value of what he got." *There is no evidence that the fraud affected the merged corporation's ability to produce and profit. Market forces, not fraud, prevented Marietta from reaching the profit thresholds set in the earnout clause.*

(Pet. App. 12a-13a (emphasis added)). The court of appeals affirmed the judgment, and subsequently denied Petitioner's petition for rehearing and rehearing *en banc*. (Pet. App. 20a-21a).

REASONS FOR DENYING THE WRIT

Petitioner contends that the courts below misapplied the concept of "loss causation," and that their error is a symptom of deep confusion among the courts of appeals about that concept. Petitioner argues that the court of appeals erred by holding — allegedly in conflict with decisions of other Circuits — that loss causation was not established even though "securities fraud was committed by misrepresentations . . . *and the loss suffered was due to the materialization of the risk which was misrepresented.*" (Pet. i, 12 (emphasis added)). Petitioner's contention is wrong, however, because he mischaracterizes: (1) the findings of fact of the district court; (2) the holding of the court of appeals in this case; and (3) the holdings of the circuit courts with which the decision below is allegedly in conflict. Since the fact-specific decision of the trial court, which was affirmed below, does not conflict with any decision of this Court or of any court of appeals, further review is unwarranted.

I.

THE DISTRICT COURT FOUND THAT THE FAILURE OF THE EARNOUT WAS NOT PROXIMATELY CAUSED BY THE DEFENDANTS' FRAUD.

The district court found as a matter of fact that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a). Petitioner never challenged that finding, and the court of appeals affirmed it. ("Market forces, not fraud, prevented Marietta from reaching the profit thresholds set out in the earnout clause.") (*See* Pet. App. 13a, quoted *supra*).

This factual finding mandates the conclusion of the court of appeals that "[Petitioner's] attempt to collect the earnout shortfall fails because the out-of-pocket measurement allows a plaintiff to recover only such losses as are proximately caused by the fraud." (Pet. App. 13a (citation omitted)). At bottom, Petitioner's disagreement with the court of appeals and the district court is a factual one: Petitioner contends that the failure of the Earnout to generate as much money as he had expected was proximately caused by the defendants' fraud, but the district court found "no evidence" in support of Petitioner's contention, and the court of appeals affirmed that factual finding.

Petitioner consistently misrepresents the record below, especially the district court's factual finding. For example, Petitioner states that his "loss resulted from the materialization of the same risk that was misrepresented," (Pet. 12), that "the investment risk misrepresented was the same risk that materialized," (Pet. 14), that "[the defendants' fraud] went to the heart of the earnout," (Pet. 16), and that "[Petitioner] proved that . . . the loss resulted from the materialization of that very risk" that was the subject of the defendants' fraud (Pet. 20). Each of these representations is refuted by the district court's finding of fact that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a (quoted *supra*)). Petitioner never makes reference to that finding.

II.

PETITIONER MISREPRESENTS THE HOLDING OF THE COURT OF APPEALS.

Petitioner contends that the court of appeals misapplied the law, and therefore came into conflict with several other courts of appeals:

> The Sixth Circuit held that even though . . . [Petitioner's] loss resulted from the materialization of the same risk that was misrepresented, he failed to prove "loss causation." In so holding, the Sixth Circuit decision is in conflict with decisions of the Second, Fifth, Eighth, Ninth and Eleventh Circuits.

(Pet. 12). Neither the district court nor the court of appeals, however, barred Petitioner from recovering for loss that was proximately caused by the defendants' fraud. The district court found, and the court of appeals affirmed, that there was no evidence that the defendants' fraud was the proximate cause of Petitioner's Earnout-related loss. In other words, the court of appeals did *not* hold that "even though [Petitioner's] loss resulted from the materialization of the same risk that was misrepresented, he failed to prove 'loss causation.' " (Pet. 12). Rather, the court found exactly the opposite: Petitioner could not recover for his losses because the losses resulted from "[m]arket forces, not fraud." (Pet. App. 13a).

The court of appeals' analysis in this case was consistent with the holdings of all of the other circuit courts

of appeals: Loss causation is an element of a securities fraud claim.[1] Because Petitioner had not shown loss causation and the district court's valuation of the Earnout was not erroneous, the court of appeals affirmed the conclusion that Petitioner was not entitled to recover for the disappointing results of the Earnout. (Pet. App. 14a ("Because there is no evidence that the fraud was the proximate cause of Marietta's inability to earn beyond the thresholds, the district court's findings will not be disturbed.")

III.

PETITIONER MISREPRESENTS THE HOLDINGS OF OTHER COURTS OF APPEALS.

Petitioner further contends that cases from other circuits hold that where parties are in privity there is no need to prove loss causation. (*See* Pet. 12.) None of the cases that Petitioner cites stands for so broad a proposition. At least two of the cases he cites directly contradict the proposition. *See Bastian v. Petren Resources, Corp.*, 892 F.2d 680, 683-86 (7th Cir.) (privity between buyer and seller; *held*: plaintiff must establish loss causation), *cert. denied*, 496 U.S. 906

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1. *See, e.g., Weiss v. Wittcoff*, 966 F.2d 109, 111 (2d Cir. 1992); *Ketchum v. Green*, 557 F.2d 1022, 1029 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983); *Fryling v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 593 F.2d 736, 744 (6th Cir. 1979); *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 684-85 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1327-28 (8th Cir. 1991), *aff'd on other grds.*, 507 U.S. 170 (1993); *McGonigle v. Combs*, 968 F.2d 810, 819 (9th Cir. 1992); *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989).

(1990) (Pet. 14-15); *In re Letterman Bros. Energy Sec. Litig.*, 799 F.2d 967, 972-73 (5th Cir. 1986) (same), *cert. denied*, 480 U.S. 918 (1987) (Pet. 13).

All of the remaining cases cited by Petitioner either expressly require a finding of loss causation under Rule 10b-5 — *see Bruschi v. Brown*, 876 F.2d 1526 (11th Cir. 1989) (Pet. 13); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir.), *cert. denied*, 502 U.S. 967 (1991) (Pet. 13) — or dispense with the requirement of loss causation because they apply the rescissory method of damage calculation, *see Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 772 n.4 (9th Cir. 1984) (Pet. 13); *Marbury Management Inc. v. Kohn*, 629 F.2d 705, 707 (2d Cir.), *cert denied*, 449 U.S. 1011 (1980) (Pet. 13); *Chasins v. Smith, Barney & Co. Inc.*, 438 F.2d 1167, 1173 (2d Cir. 1970) (Pet. 13, 22); *Garnatz v. Stifel, Nicholas & Co., Inc.* 559 F.2d 1357, 1360-61 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978) (Pet. 13, 17); *Harris v. Union Electric Co.*, 787 F.2d 355, 367-68 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1335-36 (8th Cir. 1991), *aff'd*, 507 U.S. 170 (1993) (Pet. 13).[2] By contrast, the district court in the instant case applied the out-of-pocket method of damage calculation.

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2. All but two of the cases cited by Petitioner that employed the rescissory method to calculate damages (*Harris* and *Arthur Young*) involved fraud by a fiduciary perpetrated against the purported beneficiary: Three of them involved customers suing their own brokers for churning or for recommending obviously inappropriate securities (*Hatrock*, *Brushi* and *Garnatz*); one involved a broker falsely representing that he was a licenced broker (*Marbury Management*); and one involved a broker's failure to reveal that his firm was the market maker in a security that the broker was recommending to the investors (*Chasins*). None of these cases involved falsified financial statements by a seller of securities at arm's length, as was the case here.

Although the rescissory method may be appropriate in some cases, *see Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986), the out-of-pocket method is the preferred method — *see, e.g.*, *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Stone v. Kirk*, 8 F.3d 1079, 1082 (6th Cir. 1993); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) — and it was not error for the district court to apply it, particularly in the circumstance of this case. In any event, Petitioner has waived any claim that the use of the out-of-pocket method was error because Petitioner, on appeal, did not allege that it was error for the court not to use the rescissory method. (*See* Pet. App. 5a).

CONCLUSION

For the reasons given above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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